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# TAX REFORM

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Fixing the  
Foundations

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## Summary

The reliance on fixed tax steps and tax offsets in the tax system together with the lack of integration with the welfare system which has such a confusing plethora of benefits and allowances makes our tax and welfare system in need of serious reform.

In order to provide a consistent treatment of transfer payments, the most practical solution is to treat all payments as taxable. A new system of adjustable thresholds will neutralise any adverse consequences. It is also proposed to abolish fixed tax steps and tax offsets and make the adjustable thresholds transferable between partners. Variable tax bands will provide more flexibility.

To enhance simplicity, the range of transfer payments are split into 3 types, the first subject to taper (like existing age pensions and Newstart benefits), the second subject to threshold reduction (for family benefits) and the third being the residual payments subject to neither taper nor threshold reduction.

Different thresholds already effectively exist in the current system, as the various offsets raise the tax free thresholds for different taxpayers. Some taxpayers, seniors for instance, currently, in effect, can transfer thresholds between members of a couple. So a system of adjustable transferable threshold is merely an extension of a feature of the current system.

Variable tax bands are designed to reintroduce a little more progressivity back into the system. The present system of tax offsets and their consequent withdrawal above a certain point raises effective rates of tax. The headline tax bands (15%, 30% etc) effectively disappear in a lot of instances as the withdrawals of offsets (and Centrelink payments) are impacted. In 2013 assuming the aspirational tax rates and steps are adopted, the low income tax offset of \$2,100, means that the 15% tax rate will only

operate from \$20,000 to \$30,000. Below that the effective rate is nil, from \$30,000 to \$37,000 the effective rate is 19%. Above \$37,000 the effective rate that will apply to most low and middle income taxpayers will be 34%. This is before the effects of Family Tax Benefits reduction. Taxpayers above \$180,000 will only face an effective rate of 40%. If a 15% tax band is \$28,000 for instance (from \$6,000 to \$34,000) then all taxpayers will be entitled to that band even if they have different tax free thresholds.

Having variable tax bands also allows for further policy adjustments to be easily made. For instance single taxpayers might be granted a larger tax band. Taxpayer over 60 receiving non assessable exempt retirement income streams might have their 15% band removed completely.

The use of tax offsets has been a lazy policy instrument for raising tax thresholds. It works in the first instance but the gradual withdrawal in turn increases effective tax rates. And then there are other side effects. Perhaps it is only tax accountants who have noticed the increasing receipt by minors of unearned income over the last few years. As the low income tax offset has increased so has the tax free threshold for minors. By 2013 minors will be able to receive unearned income (interest, dividends, trust distributions etc) of \$5,250 assuming the tax rate is reduced to 40% and the low income tax offset raised to \$2,100 in line with the aspirational goals of the current Government. It is time to abandon the current system of tax offsets.

Families and children will be recognised in the tax system in the same way as they are recognised by the welfare system. Consistency requires such an approach.

It is **not** a proposal for the taxation of the family unit. The individual remains as the taxing unit. The proposal will require minimal changes at the tax return level.

But the prospect of a possible de facto joint tax return is enough to elicit arguments that second income earners will inevitably face higher effective tax rates when they re-enter the workforce. But this will not occur under this proposal

The variable bands as proposed cannot be transferred between partners. This means that when a partner enters the work force he/she faces the same tax rates as everyone else. The only consequential effect is that the increased joint income will reduce the adjustable threshold which will affect the effective marginal rate. The marginal rate of most second income earners will be 0%, 15% or 30%. The effective rate will only be 10% or 13% greater.

In all cases where tax payable exceeds the amount of transfer payments received, there will be provision for those taxpayers to exit the welfare system in return for a lower level of tax deductions from their regular income, be it wages and salaries or business income. This will minimise the costs of churning.

The administrative requirements for such a change are minimal. The system of paper Employment Declarations from employees is a little antiquated and in need of overhaul, so improving the PAYG withholding section of the ATO to cope with families exiting the churn system will not be difficult and the burden on employers minimal only.

The paper describes the current system and then the proposed alternative is set out in some detail. The paper concentrates mainly on singles and couples, with or without children and with or without Newstart assistance.

Extending the system to age pensioners is easy, the only stumbling block from an equity viewpoint is the policy to preserve tax free super payouts to over 60s. A more detailed discussion on this matter is contained in the Appendix. The full implications from the Better Superannuation changes for over 60s are yet to be widely felt or understood. Superannuation for the top 5% is starting to move beyond providing retirement income streams. It is becoming an important estate planning tool, as a means to vest favours on future generations. This public policy issue needs broad discussion, and is beyond the scope of this paper.

The extension of child care assistance over the last few years imposed on the existing teetering system will inevitably grow in much the same way as universal child endowment has morphed into a system of base rate Family Tax Benefit A for low and middle income earners, extra Benefits for low income earners, plus Family Tax Benefit B for stay at home partners.

Already child care assistance includes a benefit which is usually paid as a Medicare style bulk billing amount to the provider plus a rebate which will be paid at the end of the year to the claimant. Arguably childcare support is just part of the system of family income support and it needs to be included as such.

The system of adjustable transferable thresholds and variable bands will provide better foundations for future policy implementation. Reforming, streamlining and integrating the systems as suggested will enhance simplicity, fairness and efficiency.

## Glossary

AP	age pension
ATO	Australian Tax Office
BO	beneficiary tax offset
CL	Centrelink
DIY	do it yourself Superannuation fund
DSP	Disability Support Pension
EMTR	effective marginal tax rate
FTB	Family Tax Benefit generally
FTBA	Family Tax Benefit Part A
FTBB	Family Tax Benefit Part B
LITO	low income tax offset
MWTO	mature workers tax offset
NS	Newstart
OI	other income
PA	parenting allowance
PAYG	pay as you go withholding tax
RBL	reasonable benefits limit
SATO	senior Australian tax offset
TI	taxable income
TRP	transition to retirement pension
TT	adjustable transferable threshold
VB	variable tax band

The bulk of the paper was written in June 2008. The rates and amounts used are for the year 2007/08.

## Introduction

The tax reform debate is characterised by a large gulf between economists, most of whom have little working knowledge of the current tax system, and accountants who abandoned the study of economics after the completion of Economics 101. It makes it difficult for others to participate in the debate if the persons with skills in the area cannot help construct a framework and present a list of practical reform options.

The maze of anomalies, inequities and plain old fashioned complications don't trouble most accountants. They're used to it, as the tax legislation now exceeds 10,000 pages. Anomalies and inequities represent planning opportunities. And they usually only complain about the injustices, they don't always draw attention to the generous concessions.

The problems with high effective rates of taxes, the perils of a system of joint taxation and the problems with churning are described with regularity but proposed solutions are scarce.

The aim of this paper is to address this oversight, first by outlining some key aspects of the current systems. An alternative will then be detailed.

The alternative proposal is designed to

- Fully integrate the tax and the transfer (Centrelink CL) systems
- Introduce a threshold for each taxpayer/family which is transferable between partners
- Introduce variable tax bands rather than fixed tax steps.
- Smooth and curtail the influence of high effective marginal tax rates EMTRs<sup>1</sup>

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<sup>1</sup> An EMTR is the amount of tax paid, offsets lost (or gained) and benefits lost for each extra \$ of income.



- Remove all individuals/families from the welfare system once tax on their employment and business income exceeds welfare payments.
- Abolish where possible all levies and surcharges, and rebates associated with the tax and welfare systems.

## The Current System

1. The current system recycles large amounts of personal tax collections back to taxpayers in the form of benefits and allowances. This seems inefficient
2. High effective marginal tax rates EMTRs acts as a disincentive to move away from the welfare system
3. But the high and lumpy EMTRs vary from year to year and policy responses are forever focussing on the shifting the ' lump in the hose', rather than the all important 'flow through the hose'.
4. High rates of tax act as a disincentive for taxpayers to increase income.
5. A large array of policy variables currently exist
  - Four tax steps which implies five tax bands
  - A Medicare levy which is means tested.
  - A Medicare surcharge which is means tested but only applied to those who refuse the Government's offer of assistance to participate in the inefficient and wasteful channelling of funds into the health system via private insurers.
  - Numerous offsets
    - ◆ Some relate only to CL recipients e.g. pensioner and beneficiary offsets
    - ◆ Some are generally available e.g. low income tax offset LITO (even minors get a low income offset on their unearned income)
    - ◆ Some relate to particular taxpayers e.g. Senior Australian SATO, and the dependent spouse offset (which now only applies to couples without children)

- ◆ Some are transferable to spouses e.g. SATO
- ◆ Some are only notional e.g. children's offset used to calculate zone offset for instance
- ◆ Some shade out and lead to increases in EMTR during the shade out period e.g. SATO, pensioner and LITO.
- ◆ Some shade in e.g. mature age workers tax offset MWTO up to a maximum of \$500, causing a reduction in EMTRs, before eventually being phased out.
- A huge array of Centrelink (CL) payments,
  - ◆ some taxable and some exempt from tax
  - ◆ some are means tested, others not.
  - ◆ some are assets tested
  - ◆ some include deemed income in the incomes test, some include taxable income and some include adjusted taxable income.

The system of CL payments is recognised as delivering directly targeted benefits, but the confusing plethora of policy variables and mechanisms when meshed with the tax system, creates an amazing hotchpotch which is in need of a serious overhaul.

Take the case of a single person, no NS and no children. There may be only 5 tax bands but there are actually 8 EMRT bands as shown in the following table.

**Table 1: Single no NS no children**

From	To	EMTR	Tax at top of range	
0	11000	0.0%	0	includes full LITO
11001	17309	15.0%	946	includes full LITO
17310	20364	25.0%	1710	MC levy shades in
20365	30000	16.5%	3300	includes full MC levy
30001	48749	35.5%	9956	tax rate change & LITO shades out
48750	75000	31.5%	18225	up to next tax step
75001	150000	41.5%	49350	tax step
150001	limit	46.5%	limit	tax step

At this stage the EMTRs are not that much different than the tax rates, but just a little bumpier as MC is shaded in and LITO is phased out.

But when NS is introduced into the policy mix, the single taxpayer ends up facing 12 EMTR bands. From \$12,978 to \$21,368 EMTRs exceed 50%. High EMTRs occur as NS is tapered at either 50% or 60%, the BO is withdrawn and MC is shaded in. This is the area that concerns policy makers trying to get taxpayers from welfare to work.

**Table 2:Single with NS no children**

From	To	EMTR <sup>2</sup>	Taper rate	Tax rate	Tax at top of range	
0	11365	0.0%	0.0%	0.0%	0	Full NS ,BO and LITO
11366	12977	0.0%	0.0%	0.0%	0	Full NS + max OI before NS taper
12978	14671	50.0%	50.0%	0.0%	0	50 % taper start LITO offsets tax until OI=\$5000 (15% on \$5000=max LITO of \$750)
14672	15421	65.0%	50.0%	30.0%	225	50% taper until OI=\$6500
15422	16740	75.0%	60.0%	37.5%	720	60% taper starts
16741	17309	79.0%	60.0%	47.5%	990	60% taper until NS falls to \$6000 and BO ceases & start of MClevy shade in
17310	20364	70.0%	60.0%	25.0%	1754	MC levy fully phased in
20365	21368	66.6%	60.0%	16.5%	1919	NS ceases full MC levy
21369	30000	16.5%	0.0%	16.5%	3300	incl full MClevy
30001	48750	35.5%	0.0%	35.5%	9956	tax step & LITO shade out begins
48751	75000	31.5%	0.0%	31.5%	18225	up to next tax step
75001	150000	41.5%	0.0%	41.5%	49350	tax step
150001	limit	46.5%	0.0%	46.5%	limit	tax step

It gets worse if children are introduced; say 2 children under 13. There are now 16 EMTR bands .EMTRs are very high as NS is tapered. EMTRs again exceed 50% as FTBA is phased out.

<sup>2</sup> The EMTR is the sum of the tax rate plus the taper rate adjusted for the tax effects of the taper. E.g. if the taper rate is 50% and the tax rate is 30%, the after tax taper rate is 35% (taper rate times 70%). Hence the EMTR becomes 65%.

**Table 3: Single with NS, 2 children say, under 13 years**

From	To	EMTR <sup>3</sup>	Taper rate	Tax rate	Tax at top of range	
0	12293	0.0%	0.0%	0.0%	0	Full NS ,BO and LITO
12294	13905	0.0%	0.0%	0.0%	0	Full NS + max OI before NS taper
13906	15599	50.0%	50.0%	0.0%	0	50% taper start LITO offsets tax until OI=\$5,000
15600	16349	65.0%	50.0%	30.0%	225	50% taper until OI=\$6500, BO reduced
16350	18915	75.0%	60.0%	37.5%	1187	60% taper &BO ceases
18916	22915	66.0%	60.0%	15.0%	1787	60% taper continues no BO
22916	30000	15.0%	0.0%	15.0%	2850	tax only full LITO no MC levy
30001	34571	34.0%	0.0%	34.0%	4404	tax change & LITO shade out starts
34572	40672	44.0%	0.0%	44.0%	7089	MC levy shading in
40673	41319	35.5%	0.0%	35.5%	7318	LITO reduction continues
41320	48749	55.5%	20.0%	35.5%	9956	FTBA reduction starts & LITO ceases
48750	67013	51.5%	20.0%	31.5%	15709	FTBA reduction completed
67014	75000	31.5%	0.0%	31.5%	18225	breather!
75001	95192	41.5%	0.0%	41.5%	26605	tax step
95193	107797	71.5%	30.0%	41.5%	31836	FTBA basic reduction
107798	150000	41.5%	0.0%	41.5%	49350	tax + MC levy only
150001	limit	46.5%	0.0%	46.5%	limit	tax step

The pattern is similar in the case of couples, but is even more complicated if there's FTBB.

And when workers are over 55, the EMTRs are affected by the MWTO and after 65, SATO will apply.

Some summary comments at this stage follow.

1. High EMTRs are produced by 4 factors.
  - The withdrawal of tax offsets
  - The shading in of MC

<sup>3</sup> Where the taper relates to a tax exempt amount like FTB, an adjustment for the tax effect of the taper is not required when calculating the EMTR.

- The tapering of NS
  - The withdrawal of FTBs
2. Some offsets are withdrawn on a discontinuous basis e.g. FTBA. For a while the benefit is withdrawn at the rate of 20% then nil and then finally at 30% until fully phased out.<sup>4</sup>
  3. When the Medicare levy starts to shade in, for a short period a taxpayer faces a further increase of 10% in the EMTR.
  4. The variable EMTRs are continually changing as Governments tinker with all the parameters, whether for soundly based policy reasons or merely to satisfy the needs of the short term electoral cycle. It makes long term policy setting a little more difficult.
  5. There is a lack of uniformity in the way the tax and the CL system treat the family unit. The tax system is largely based on the individual as the taxing unit whereas CL always considers the family unit when measuring income and assets. For instance a dependent spouse with no children may be eligible for a spouse offset, but if there are children involved, any entitlement is via FTBB.
  6. Some benefits are taxable, others exempt, some subject to tapering, others means tested, some subject to offsets that reduce, and this makes it extremely difficult to maintain a system that has some semblance of internal consistency and logic. The system has simply grown like Topsy and is in serious need of an overhaul if it is to survive in a way that will contribute to sensible policy implementation in the future.
  7. There are however some features of the current system that are not widely understood and are worth mentioning because they point the way forward if the system is to be fixed
    - Senior Australians enjoy a tax offset SATO (which raises their tax free threshold) and which is subsequently withdrawn at the rate of 12.5%, and which if not fully withdrawn is then transferable to a spouse. It

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<sup>4</sup> Although not shown, FTBB is not phased out at all for singles and stay at home mothers.

means that members of a couple don't have to carefully make investments in correct names as was previously the case, because any unused offset is transferable to a spouse. This is one example of the tax system recognising the family unit and enabling the transfer of offsets between partners.

- NS beneficiaries are allowed an offset which offsets the amount of tax payable to nil on the amount of the benefit exceeding \$6000. This effectively raises the tax free threshold for such beneficiaries
- A partner of a NS beneficiary often receives a parenting payment equal to the NS benefit. And because a beneficiary tax offset applies to both, it means that the family effectively has a raised tax free threshold.
- A single person doesn't pay a Medicare levy until income reaches \$16741<sup>5</sup>. And in the case of a family the threshold is calculated according to the number of dependent children. Joint income is then used to determine the amount of the levy. If a reduced levy becomes payable it is apportioned between the 2 partners. This is another example of the family unit being used, in this case to determine a joint threshold for the application of the Medicare levy.
- When all tax returns have been lodged by a family, the ATO now reconciles family income with the amount of FTB received and adjusts the amount of FTB. This may lead to a refund or an amount payable. This has been a welcome initiative. The reconciliation procedure is most efficient, with assessments being issued within the same time as other assessments. Previously there was no recourse to unclaimed amounts although over- paid amounts were always claimed back by CL
- Taxpayers can elect to receive their FTB entitlements via the tax system. It is even possible, yet few taxpayers avail themselves of the opportunity, to reduce the amounts of tax withheld from wages, as a way of benefiting from FTB, with a settlement upon issue of the tax assessment.

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<sup>5</sup> For 2006/07. The recently announced figure for 2007/08 is \$17.309.

- The ATO (and Centrelink) do have some well developed data bases and online facilities. Tax practitioners for instance are able to access the Tax Portal which provides a Pre Filling Report for amounts received by taxpayers, as reported to the ATO. Whilst incomplete at this stage it includes Payment Summaries, FTB, Child Care Benefits, dividends, interest and managed fund income. It is a powerful database.
- CL now allows for a lot of reporting and updating of personal details.
- When a taxpayer lodges a return that results in an amount payable, the ATO may issue, in addition to an assessment, a notice of PAYG instalments that will become payable in the ensuing year based on the ATO's estimate of the ensuing year's income.

## Proposal

Most discussion on tax reform canvasses either the abolition, or the raising, of tax free thresholds. The threshold, whatever it may be, is always assumed to be the same for all taxpayers. Also most tax reform proposals persist with the system of fixed tax steps together with rebates/offsets which are gradually withdrawn above a certain point<sup>6</sup>.

Whereas once the tax system and the welfare system were separate and discrete, the rise and rise of middle class welfare has meant that increasing numbers of people are involved with both systems and a lot of \$s collected as tax revenue are subsequently recycled back via the transfer system.

The proposal is as follows

1. Make all payments taxable, including FTBs and DSPs

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<sup>6</sup> The Terms of Reference of the Tax Review refers to aspirational goals of certain fixed tax steps (15%, 30% and 40%) and a LITO of \$2,100, by 2013/14.



2. Abolish the standard tax free threshold and replace it with a threshold calculated according to a taxpayer's circumstances.
3. Replace the current system of fixed tax steps with a system of variable tax bands (VBs).
4. Abolish all offsets associated with CL payments, as well as the generally available low income offset, and incorporate them into the tax rates. This will deal with one of the predisposing factors causing high EMTRs.
5. Abolish the Medicare levy and incorporate it into the tax scales. This will deal with the second of the factors leading to high EMTRs.
6. Make every \$ taxable from \$1 upwards, but subject to a taxpayer's individual tax free threshold
7. In the case of partners, any threshold is calculated on a family unit basis and split between partners. Any unused threshold of one partner is transferred to the other partner (a transferable threshold or TT) in much the same way as the current Senior Australian SATO offset.
8. A family's TT to include an amount for each dependent child
9. Abolish other offsets such as spouse offset and incorporate them in the TT.
10. Try where possible to organise the tapering of NS under the TT or at least before any TT reductions, so EMTR effects are minimised. (It is when tapering occurs simultaneously with offset adjustments and tax imposition that high EMTRs result).
11. Set a goal that no EMTRs exceed 50%.
12. Gradually adjust the TT downwards once the stipulated income amounts are exceeded, until basic adult thresholds are reached.
13. Standardise all CL payments by categorising them as follows.
  1. Type 1--- taxable subject to income taper of 40% e.g. NS & Age pensions
  2. Type 2--- taxable but subject to TT reduction for incomes above a threshold, at the rate of \$1 in every \$3 e.g. standard FTB for children
  3. Type 3--- taxable but not subject to TT reduction. E.g. maybe some specially targeted benefits if needed. The TT can be raised to make them tax free if necessary.

14. Encourage all taxpayers to opt out of the CL system if possible. With raised transferable thresholds, all taxpayers whose PAYG withholding amounts exceed their CL payments (mainly FTB) will be offered a TT amount by the ATO/CL which can be quoted to an employer to reduce PAYG withholding amounts (instead of receiving the churned amounts of FTB).
15. The ATO issue a notice indicating an estimate of the taxpayer's TT or the family's TT, as the case may be. At any stage a taxpayer can self assess a revised threshold.
16. The TT advice from the ATO to be used on Employment Declarations to determine the amount of PAYG withholding deductions.
17. Use the TT system to help administer other policies if applicable eg child care rebate.

The question arises, why make all CL payments taxable? Won't this simply increase the churn? Well yes it will, but introducing some uniformity and consistency should perhaps be a priority.

The alternative is making them all exempt from tax. That may lead to even more problems. Instead make them all taxable, and address the churn problem separately, by removing all those whose tax payable exceeds their CL benefits, from the welfare system.

Also the question arises as to why use tapers on some occasions and TT reductions on other. The answer is pragmatic.

- If CL payment adjustment is to occur under the TT (this is the case with a lot of NSers and age pensioners) then a taper is the only approach.
- Some CL payments require assets testing and incomes testing based on deemed incomes, hence TT reductions which are based on TI are not appropriate.
- NSers need to satisfy additional work tests, hence the taper system, administratively speaking, is not much of an additional burden.

## Calculating the TT

A system of thresholds is suggested as follows.

Adults	\$11000 each
Child 1	\$ 8000 each
Child 2+	\$6000 each
Single Supplement	\$2000

It is assumed here that all children are minors.

The rationale for allowing children to be reflected in the family's TT at this stage is as follows.

- If the 2 systems are to be integrated, children need to be considered. Children are often the focus of the CL system but not the tax system.
- But if all CL payments are to be taxable then threshold amounts need to be included for children.
- With taxable income TI below the threshold TT no tax is payable on FTB but at some later stage the TT starts to reduce.
- When TT reduction is completed, the FTB is simply taxed at the taxpayer's marginal tax rate which leaves the taxpayer with an amount of FTB after tax. This means all children receive a certain basic level of subsistence.

A return to the universality of Child Endowment perhaps?

But if public policy demands that high income earners lose all of their FTB at a certain point, it is a simple matter to continue the TT reduction below the standard adult TT amount of \$11,000, until the FTB is effectively 100% taxed.

## Other Assumptions

### Tax bands VBs

#### Adults

15%	\$17,000
30%	\$45,000
40%	\$75,000
45%	unlimited

The existing CL system makes a distinction between singles and members of a couple. The above VBs therefore can be varied between singles with children and other adults but at this stage a uniform set of VBs is adopted.

The deficiencies of having fixed steps will be highlighted below.

Together with a variable TT, the VB will offer more flexibility than the current system of fixed bands and fixed tax steps, where tapers and offset reductions spill into the next tax band with consequent lumpy and higher EMTRs.

Different TTs and VBs will be introduced below to cater for over 65s.

### Payments

The following are the amounts used in the models. The purpose at this stage is to construct the model. The amounts are not intended to be the author's view on the 'correct' level of payments.

NS Adult single	\$12,000	Type 1
NS Adult couple	\$20,000	Type 1
FTB per child	\$4,000	Type 2

### Taper details

Taper rate NS	40%	
End of taper singles	\$30,000	applies to Type 1
End of taper couples	\$50,000	applies to Type 1

### TT reduction details

Start of TT reduction \$48,000 for Type 2 benefits

Rate of TT reduction \$1 in \$3 for Type 2 benefits based on entitlement

Note: The reduction and the taper thresholds exclude FTBs

### TT adjustments

Let's now look at how FTBs are clawed back via TT reduction.

**Table 4 : Couple No NS Other Income (OI)= \$41,000**

No kids	TT Total	FTB	Start of TT adj re FTB	End of TT adj re FTB	Adjusted TT	TI	Tax	net	EMTR
0	22000	0	48000	48000	22000	41000	3150	37850	30%
1	30000	4000	48000	72000	30000	45000	2250	42750	15%
2	36000	8000	48000	90000	36000	49000	1950	47050	15%
3	42000	12000	48000	108000	42000	53000	1650	51350	15%
4	48000	16000	48000	126000	48000	57000	1350	55650	15%
5	54000	20000	48000	144000	54000	61000	1050	59950	15%

In the above example a family with children with nil NS and other income OI of \$41000, face an EMTR of 15%. The TT adjustment doesn't start until OI equals \$48000.

Where OI equals \$51000 the situation becomes

**Table 5 : Couple No NS Other Income (OI)= \$51,000**

No kids	TT Total	FTB	Start of TT adj re FTB	End of TT adj re FTB	Adjusted TT	TI	Tax	net	EMTR
0	22000	0	48000	48000	22000	51000	6150	44850	30%
1	30000	4000	48000	72000	29000	55000	5250	49750	40%
2	36000	8000	48000	90000	35000	59000	4650	54350	40%
3	42000	12000	48000	108000	41000	63000	4050	58950	40%
4	48000	16000	48000	126000	47000	67000	3450	63550	40%
5	54000	20000	48000	144000	53000	71000	2850	68150	40%

When TT reduction starts at \$48,000 the EMTR becomes 40%. With OI of \$48,000, \$3,000 in excess of start of TT reduction, TT is only reduced by \$1,000. This leads to the EMTR rising from 30% to 40%.

**Table 6 : Couple No NS Other Income (OI)= \$81,000**

No kids	TT Total	FTB	Start of TT adj re FTB	End of TT adj re FTB	Adjusted TT	TI	Tax	net	EMTR
0	22000	0	48000	48000	22000	81000	15150	65850	30%
1	30000	4000	48000	72000	22000	85000	16450	68550	40%
2	36000	8000	48000	90000	25000	89000	16850	72150	53%
3	42000	12000	48000	108000	31000	93000	16050	76950	40%
4	48000	16000	48000	126000	37000	97000	15450	81550	40%
5	54000	20000	48000	144000	43000	101000	14850	86150	40%

In this case the EMTR is 40% except when the tax rate changes from 30% to 40%, the EMTR changes from 40% to 53% whilst TT reduction continues.

Once TT is adjustment is completed, the EMTR becomes 40% (or 45% for TI in excess of \$150000). The table below illustrates this latter point.

**Table 7 : Couple No NS Other Income (OI)= \$151,000**

No kids	TT Total	FTB	Start of TT adj re FTB	End of TT adj re FTB	Adjusted TT	TI	Tax	net	EMTR
0	22000	0	48000	48000	22000	151000	42850	108150	40%
1	30000	4000	48000	72000	22000	155000	44450	110550	40%
2	36000	8000	48000	90000	22000	159000	46050	112950	40%
3	42000	12000	48000	108000	22000	163000	47850	115150	45%
4	48000	16000	48000	126000	22000	167000	49650	117350	45%
5	54000	20000	48000	144000	22000	171000	51450	119550	45%

The salient feature of the above table is that TT is reduced to \$22,000, being the TT amount for 2 adults. Also note the net amount increases at the rate of either \$2,400 or \$2,200 for every extra child. This amount represents the after tax amount of the FTB (\$4,000 less 40% or 45%) and is the subsistence entitlement of a child.

As previously mentioned, if public policy requires that high income earners lose all of their FTB entitlement, then it is a simple matter to continue TT reduction until FTB is effectively 100% taxed.

The last 4 tables showing varying situations for a couple with children but no NS, assumes that all income is earned by the primary breadwinner and that he/she therefore receives all TT amounts. The tables show how TTs move as income and the number of children alters, and may look complicated, but in practice the calculation for each taxpayer/family is quite easy. Simply allow a threshold amount for each adult, add the amounts for dependent children and then make a reduction adjustment in respect of FTB based on the level of other income (OI). All this information is easily available. In fact the ATO and CL use this very information to reconcile current FTB entitlements.

TTs in respect of dependent children are freely transferable between partners. Also any unused TT amounts for adults can be transferred.

The current system phases out FTBs in 2 tranches, the first at the 20% rate, and then after a breather (in most cases) at the 30% rate. The above is a much simpler system, a continuous stream that only increases EMTRs by 1/3<sup>rd</sup> of their relevant tax rate.<sup>7</sup>

All taxpayer are entitled to FTB for dependent children. But where a taxpayer's expected tax exceeds the FTB entitlement, a taxpayer should be encouraged to forgo the cash amount and opt instead for reduced PAYG from his/her wages. It will save on the churn costs.

If a taxpayer forgoes receiving his cash FTB entitlement, this does not mean he surrenders his FTB entitlement. He/she will instead be credited for the uncollected entitlement at year's end. For example, say with 2 children and nil FTB paid, the taxpayer will simply be issued with a Payment Summary from CL showing an \$8000 gross amount with PAYG credits of \$8000, which is then simply included on the individual's tax return.

And it may even be possible to bypass the issuing of a Payment Summary. Details of such payments (and interest received for instance) are now available via the ATO portal for each taxpayer

The question of the threshold amounts when tax payable exceeds CL benefits will be revisited below, but it may be best to first introduce the provision of NS into the equation.

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<sup>7</sup> From 30% to 40% for the 30% VB, and from 40% to 53% for the 40% VB. Under the model under discussion it is likely that all TT reduction will be completed before the onset of the 45% VB.



Consider the case of a single with no children. The table below shows how NS is phased out when OI reaches \$30,000. With the taper operating below the TT, the EMTR is only 40% (equal to the taper rate). When tax starts, the EMTR reaches a maximum of 49%.<sup>8</sup>

**Table 8 :Single NS No Children**

TT	13000	13000	13000	13000	13000	13000	13000
Other							
Income	0	1678	4000	6000	11000	25000	30000
NS	12000	11329	10400	9600	7600	2000	0
FTB	0	0	0	0	0	0	0
TI	12000	13007	14400	15600	18600	27000	30000
Tax	0	1	210	390	840	2100	2550
Net	12000	13006	14190	15210	17760	24900	27450
EMTR		40%	49%	49%	49%	49%	49%

At TI = \$30,000, tax payable of \$2,550 is identical to a non NS single.

The case of a single with NS and 2 children is as follows.

**Table 9 :Single NS 2 Children**

TT	27000	27000	27000	27000	27000	27000	27000
Other							
Income	0	1678	4000	6000	11000	25000	30000
NS	12000	11329	10400	9600	7600	2000	0
FTB	8000	8000	8000	8000	8000	8000	8000
TI	20000	21007	22400	23600	26600	35000	38000
Tax	0	0	0	0	0	1200	1650
Net	20000	21007	22400	23600	26600	33800	36350
EMTR		40%	40%	40%	40%	49%	49%

The EMTRs are similar, a maximum of 49%

With TI above \$30,000, the EMTR (and the tax rate) remain at 30% until \$48,000 when TT starts to reduce due to FTB. The effects are identical to that shown above for couples.

<sup>8</sup> 40% taper rate plus 15% tax on the remaining 60% or 15% tax plus the after tax effect of the taper of 34% (i.e. 85% of 40%)

Let's take a look when OI = \$41,000.

**Table 10 : Single No NS OI=\$41,000**

No kids	TT Total	FTB	Start of TT adj re FTB	End of TT adj re FTB	Adjusted TT	TI	Tax	net	EMTR
0	13000	0	48000	48000	13000	41000	5850	35150	30%
1	21000	4000	48000	72000	21000	45000	4650	40350	30%
2	27000	8000	48000	90000	27000	49000	4050	44950	30%
3	33000	12000	48000	108000	33000	53000	3450	49550	30%
4	39000	16000	48000	126000	39000	57000	2850	54150	30%
5	45000	20000	48000	144000	45000	61000	2400	58600	15%

The EMTR is equal to the VB rate as TT reduction hasn't started yet. TT reduction will commence at \$48,000.

At OI= \$51,000 the situation is as follows

**Table 11 : Single No NS OI=\$51,000**

No kids	TT Total	FTB	Start of TT adj re FTB	End of TT adj re FTB	Adjusted TT	TI	Tax	net	EMTR
0	13000	0	48000	48000	13000	51000	8850	42150	30%
1	21000	4000	48000	72000	20000	55000	7950	47050	40%
2	27000	8000	48000	90000	26000	59000	7350	51650	40%
3	33000	12000	48000	108000	32000	63000	6750	56250	40%
4	39000	16000	48000	126000	38000	67000	6150	60850	40%
5	45000	20000	48000	144000	44000	71000	5550	65450	40%

Again EMTRs increase by up to 10% as TT reduction starts. So generally speaking, increased income will lead to similar patterns of tax and EMTR increases as already outlined for couples above.

Now let's consider the case of a couple with NS and with children, say 2 children. Whilst TTs are based on a family unit it is individuals who are taxed. In the case of couples on NS, the payments are split between partners, often the secondary earner receiving a

Parenting Allowance PA rather than NS. In reality the payment amounts are similar and I have proceeded on that basis, calling all payments NS payments.

**Table 11: Couple both on NS 2 children**

TT 100%	36000	36000	36000	36000	36000	36000	36000	36000
TT 50%	18000	18000	18000	18000	18000	18000	18000	18000
OI 100%	0	2000	4000	13000	20000	30000	40000	50000
NS 100%	20000	19200	18400	14800	12000	8000	4000	0
FTB 100%	8000	8000	8000	8000	8000	8000	8000	8000
TI 100%	28000	29200	30400	35800	40000	46000	52000	58000
TI 50%	14000	14600	15200	17900	20000	23000	26000	29000
Tax 50%	0	0	0	0	300	750	1200	1650
Net 50%	14000	14600	15200	17900	19700	22250	24800	27350
Tax 100%	0	0	0	0	600	1500	2400	3300
Net 100%	28000	29200	30400	35800	39400	44500	49600	54700
EMTR		40%	40%	40%	49%	49%	49%	49%

The approach used is to calculate the family income and the family TT, then split them into two, calculating the tax and net amounts, before adding them again to present the totals.

With the taper set at 40% so EMTR is again only 49%, the tax payable at the end of the taper when OI is \$50,000, is equal to \$3,300 compared to \$3,400 payable by a couple without any NS at the same level of income. The difference is because TT taper didn't commence at \$48,000 in the above table. To overcome this inequity simply increase the NS taper slightly from 40% before tax becomes payable. This will allow NS to phase out before TT reduction starts.

Now moving on beyond NS when couples might both work.

Consider the following

**Table 12 : Couple 2 children OI=\$61,000 split 70:30**

No kids	TT Total	FTB	Start of TT adj re FTB	End of TT adj re FTB	Adjusted TT	TI	Tax	net	EMTR
Partner A	25000	8000	48000	90000	20667	50700	6460	44240	44%
Partner B	11000	0	48000	48000	11000	18300	1095	17205	15%
Total	36000	8000	96000	138000	31667	69000	7555	61445	

All the children's TTs are transferred to Partner A.

In the case of OI = \$61,000 split 70:30, partner A faces an EMTR of 44%<sup>9</sup> after TT reduction starts. Partner B only faces a VB rate of 15%.

If OI increases to \$91,000 the situation becomes as follows.

**Table 13 : Couple 2 children OI=\$91,000 split 70:30**

No kids	TT Total	FTB	Start of TT adj re FTB	End of TT adj re FTB	Adjusted TT	TI	Tax	net	EMTR
Partner A	25000	8000	48000	90000	11000	71700	15660	56040	30%
Partner B	11000	0	48000	48000	11000	27300	2445	24855	15%
Total	36000	8000	96000	138000	22000	99000	18105	80895	

TT reduction is complete because it is based on joint OI. Hence the EMTRs are back to the levels in the tax scales, 30% and 15%. As a collective unit the family EMTR is only 25%.

<sup>9</sup> The 44% EMTR is brought about by the way the model is constructed. If OI increases by \$1, only 70c is assumed to go to partner A, yet his TT reduction is based on the increase in joint income i.e. \$1. Instead of the EMTR increase being 10% for a 30% VB, the increase is 10% divided by 70/100.

When OI moves to \$121,000, still split 70:30, EMTRs become 40% and 30%, with collective amount of 37%.

**Table 14 : Couple 2 children OI=\$121,000 split 70:30**

No kids	TT Total	FTB	Start of TT adj re FTB	End of TT adj re FTB	Adjusted TT	TI	Tax	net	EMTR
Partner A	25000	8000	48000	90000	11000	92700	23930	68770	40%
Partner B	11000	0	48000	48000	11000	36300	5040	31260	30%
Total	36000	8000	96000	138000	22000	129000	28970	100030	

The above examples of families where both parents work, highlight how the secondary income earner can be enticed back into the workforce because after the TT amount there is still a VB where the EMTR is only 15%. (From the TT of \$11,000 up to \$28,000, where \$2550 is payable.) So a family will effectively have at its disposal 2 variable tax bands (although these aren't transferable like TTs), whereas a single with children has only one. Perhaps a single with children needs say a \$30,000 15% band rather than a \$17,000 band? This means that 15% VB will run from the TT (which depends on the number of children, to TT plus \$30,000.) at which point the basic tax rate becomes 30%.

So to summarise the position thus far.

1. The proposal has four tax bands. Most being 97% of all taxpayers are covered by the first 3 bands.
2. TTs will be calculated for each taxpayer plus dependent children, which can then be transferred to other members of the family unit.
3. Incomes above TTs are taxed according to variable tax bands rather than fixed tax steps.
3. All CL payments will be taxable and categorised into 3 Types.
4. Abolish all levies surcharges and offsets.
5. Streamline the system; curtail the high EMTRs which inhibit taxpayers from moving up the income scale.

6. Lower the administrative costs. TTs are easy to calculate and the transfer of unused offsets such as SATO already occurs.

7. It is now possible to easily calculate the point at which tax payable exceeds CL benefits received and as a consequence large sections of the population should be encouraged (or bribed) to leave the CL system by opting for reduced PAYG deductions from their earnings in return for forgoing the cash receipt of their CL benefit. Not forgoing their entitlement, just the regular cash payments. Any cash not claimed will be simply credited at the tax return stage.

### Break Even Points

The table below shows the break even points for a single and a couple with children where all income is earned by the sole breadwinner.

**Table 15: Breakeven point where tax =FTB Single vs Couple**

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
No. kids	Tax=FTB	Single				Couple one breadwinner			
		Break even		Adjusted TT	Excess over TT	Break even		Adjusted TT	Excess over TT
		OI	TI			OI	TI		
1	4000	38833	42833	21000	21833	47833	51833	30000	21833
2	8000	52625	60625	25458	35167	59375	67375	32208	35167
3	12000	64125	76125	27625	48500	70875	82875	34375	48500
4	16000	75625	91625	29792	61833	82375	98375	36542	61833
5	20000	84656	104656	32781	71875	91406	111406	39531	71875

Column (2) indicates the FTB received, it increases with each child. Columns (3) and (7) indicate the levels of OI (NB excluding FTB) where tax payable = FTB. Columns (5) and (9) show the adjusted TTs, and columns (6) and (10) show the amounts of TI over and above the adjusted TT. Needless to say these latter amounts are the same for singles and couples with one breadwinner. This is because the VBs for each are similar.

Equity may however require that a single requires a greater 15% VB. Child care costs will presumably be greater than for a couple with only one breadwinner.

It will be a simple matter to increase the VB.

Alternatively the requirements of singles with child care needs could be addressed via increased TTs.

Table 15 also emphasises the advantage of VBs rather than fixed steps. For a single with say 2 children the adjusted TT is \$25,458. With the current regime having a fixed tax step at \$30,000, there is not much of a 15% tax band. In a more extreme case of say a couple with 5 children, their TT could be as high as \$54,000 which means that it's not too long before the current 40% fixed tax step would apply.

The situation with couples where both work (50:50) is contrasted below with the above couple with only one breadwinner.

<b>Table 16: Breakeven point where tax =FTB Couples</b>									
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
No. kids	Tax=FTB	Couple one breadwinner				Couple income split 50:50			
		Break even		Adjusted TT	Excess over TT	Break even		Adjusted TT	Excess over TT
		OI	TI			OI	TI		
1	4000	47833	51833	30000	21833	51500	55500	28833	26667
2	8000	59375	67375	32208	35167	65750	73750	30083	43667
3	12000	70875	82875	34375	48500	77250	89250	32250	57000
4	16000	82375	98375	36542	61833	88750	104750	34417	70333
5	20000	91406	111406	39531	71875	100250	120250	36583	83667

Needless to say the breakeven point where joint tax payable = FTB received, is higher in the case where both parents work. This is because each working parent has access to their own 15% VB (which is not transferable). There's appears to be fairness in this situation because the dual working parents will be facing higher child care costs than the family with only one breadwinner.

These breakeven amounts are not the TT amounts. Rather they are the levels of income at which a taxpayer having opted to forgo the cash FTB entitlement, is able to submit a revised Employment Declaration to his/her employer indicating reduced PAYG withholding amounts equal to the cash entitlement forgone. In other words, stopping the churn.

The ATO will issue a notice to each taxpayer based on the most recent tax return or the most recent information supplied to the ATO in the case of subsequent changes. This notice will indicate the amount of the family threshold and the amount to be claimed by the taxpayer (with the balance to be claimed by the taxpayer's spouse). The taxpayer will always have the opportunity to self assess and adjust the TT amount.

Once in receipt of this notice the taxpayer will complete a fresh employment declaration with their employer indicating the taxpayer's tax free threshold. Similarly for the taxpayer's partner.

There are arguments to the effect that if FTB is paid to the secondary income earner who is usually the primary carer, the amount of FTB is more likely to be spent on the intended children. If public policy requires the primary carer to receive the FTB this is easily accommodated. The person receiving the FTB can differ from the person including the FTB as income.

The proposals will result in a large majority of taxpayer being removed from the welfare system.

Instead a major point of contact with the bureaucracy will be via an enhanced PAYG section of the ATO.

Taxpayers receiving NS will continue to report their OI to CL on a regular basis. The most efficient system may well be to allow NSers to receive any income OI free of any PAYG withholding tax and instead withhold PAYG from FTB at the same time the taper is adjusted.

The ATO Tax Agent portal and other online services together with the demonstrated ability of the ATO/CL to rapidly reconcile FTB payments, means that procedures are in



place to cater for tracking thresholds. It would be an easy matter to incorporate family threshold reporting into their existing functions.

Also taxpayers will need to be vigilant with their employment declarations if more than one is in force at any particular point in time (with different employers). But then again this will be no different to the existing situation. And if anyone has ever perused the current PAYG withholding tax scales (not just one) or heaven forbid the formulae that generate the various tax scales, then it is obvious that things couldn't get any harder.

For those persons who remain fully dependent on CL there will be little change, their taxable income will be below their TT and hence lodgement of returns won't be required.

## **Extending the use of TTs**

So far only FTB and NS have been considered.

The rationale for making DSPs exempt from tax is not clear. To the extent that they are income support payments they should be included with NS as a Type 1 benefit. If there is a component that warrants special treatment, then part of the DSP could be a Type 3 benefit.

Once having established the concept of a TT, its use can then be expanded to encompass other policy questions.

For instance FTB is reduced for custodial parents in child support cases. But what about the situation of non custodial parents? Under a system of TTs in cases of, say, maintenance agreements registered with the Child Support Agency, non custodial parents would get an increase in their TT and custodial parents an equivalent TT reduction. It would make the system fairer and would be most welcome by non custodials, whose participation rate would only increase.

Reducing income by investment losses, salary sacrificing and reportable fringe benefits has an effect on the amount of FTB payable, but this effect will be less if all FTB are taxable in the first place. CL currently adjusts FTB income amounts for rental property losses and the latest Budget proposes adding other investment losses, salary sacrificed amounts and reportable fringe benefits to the list of add-backs.

The above proposal starts TT reduction for FTBs when OI reaches \$48,000. It would be a simple matter to incorporate other add backs in OI, and administratively it would be easier—no reduction in the actual FTB payable, simply an adjustment when adjusted TT is calculated.

The current debate about the ‘sudden death’ loss of the \$8,000 solar panel PV rebate when incomes reach \$100,000 again demonstrates the inadequacies of the current system.<sup>10</sup> Simply make them taxable as Type 3 benefits which come with or without an extra TT which is not reduced. If a grant of \$1 is taxable at the VB rate, then if it were intended to make it tax free, then raise the TT by \$1. Much easy to administer and fairer. And it saves all that effort involved in trying to sneak under the limit which always happens in these ‘sudden death’ cases.

## **The Problem with LITO**

The Tax Review terms of reference refers to the aspirational goals of fixed tax steps and a LITO of \$2,100 by 2013/14. Sounds like low income earners are being assisted, but let’s look at the full picture say for a family with 2 children and one breadwinner, where LITO is being raised by \$100 for example.

- If the family is below the taxable threshold there is no benefit.

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<sup>10</sup> This is not to suggest that the PV rebate is sound public policy. Like the proposed education rebate it is possibly an inaccurately targeted, inefficient use of public resources. There are more efficient ways of implementing climate change policy and providing more funds for education.

- For lower and middle income families the amount of benefit will be somewhere between \$100 and nil depending on their family income.
- But a high income family able to divert income to minors, will benefit by more than \$100.

To understand this point it is necessary to understand how minors are taxed on their unearned income (passive income such as interest, dividends, distributions from trusts etc) pursuant to Div 6AA<sup>11</sup>.

Minors are taxed at a flat rate equal to the top marginal tax rate (which in a few years time will be 40%) subject to 2 conditions.

1. The first \$416 is tax free.
2. There is then a shading in of tax at the rate of 66% until the average rate of tax is reached

Currently in 2007/08 with a LITO of \$750 and a top tax rate of 45%, the maximum tax free amount for a minor with unearned income is \$1,667.

But if LITO rises to \$2,100 and the top tax rate falls to 40% the maximum tax free amount for a minor will be \$5,250. The ATO will be flooded with newly established family trusts.

In the above example of a high income earner with 2 children, if LITO increases by \$100 each of the 2 children will receive an increased tax free threshold of \$250 (\$100 divided by the tax rate of 40%), meaning between the 2 children the increased threshold is \$500. This means that the parents can divert \$500 of income to their children, saving themselves \$200. Compare this with the fact that some lower income earners may benefit by \$100, but for most it will be a lesser figure.

Admittedly the above is a contrived example but it does emphasise

- The problems with fixed tax steps and offsets that shade out.
- The slightly farcical situation of running a Reform inquiry with certain matters (aspirational goals) off limits.

It needs to be understood that a high LITO might sound like attractive social policy but it will only exacerbate inequities.

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<sup>11</sup> The Income Tax Assessment Act 1936.

Imagine a high income earner being offered a bonus of \$5,250 (or \$3150 after 40% tax), **or** a dividend from his boss' private company of \$3675 fully franked<sup>12</sup>. The latter can pass through his family trust to his dependent child who will obtain a refund of the franking credit thus ending up with \$5250. An EMTR of 40% vs. an EMTR of 0%. Everyone should aspire to having a family trust.

Despite the proposed raising of the 30% tax step from \$30,000 in 2007/08 to \$37,000 in 2013/14, LITO will continue to shade out from \$30,000. This means that in 2013/14 the effective tax free threshold will be \$20,000 but the 15% band will only run until \$30,000 when the band effectively becomes 19% until \$37,000, when it will become 34%. The 30% rate won't start until \$82,500 when LITO runs out. Most low and middle income earners will therefore have tax rates of 34%, when the top tax rate for incomes over \$180,000 will be only 40%.

Increasing LITO is just another way of flattening the rates.

## **Minors and Tax**

The matter of unearned income for minors leads to the question of how to deal with their employment income (or excepted income as the Tax Act terms it). Some minors are 'excepted persons' e.g. they are engaged in full time work. Such persons are effectively adults for tax purposes. It is only the non excepted minors (the vast majority still in full time education) that we are considering at this point.

Currently minors with excepted (mainly employment) income are allowed the same tax free threshold as adults, as indeed are their brethren in the full time work force. That seems reasonable. The TT component for children that forms part of the family TT is separate to a threshold that a minor might apply to earned income. But any unused portion of this latter threshold is not transferable.

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<sup>12</sup> The after tax costs to the employer of the 2 options are identical.

Currently minors (not on Youth Allowance or in full time work) can earn almost \$12,000 before FTB is affected. They can be drawn into the tax system yet they are still dependents and their parents are receiving possibly full FTB. Some reduction in a family's TT is required in this instance, say \$1 for \$1 once a minor's income exceeds, let's say \$4,000.

## **TTs for Over 65s**

Historically there has arguably existed a gap between age pensioners and other CL recipients below pension age. This is something that could be rectified over a few years if public policy and marginal seats requirements were in alignment.

But the May 9<sup>th</sup> 2006 superannuation changes in turn opened up a huge gulf between superannuants and non superannuants which makes the gap between age pensioners and other CL recipients pale into insignificance.

So it is a little difficult when discussing age pensions, whether to use other CL recipients as a benchmark or to use the treatment accorded to over 60 superannuants as the benchmark.

Over the years age pensioners have been accorded special treatment compared to other CL beneficiaries

- Unused SATO is transferable between partners.
- And their level of SATO has been higher than comparable offsets for other CLers.

The following table shows all the EMTRs faced by a single senior (assume no age pension).

**Table 17: Single Senior No Age Pension**

From	To	EMTR	Tax at top of range	
0	26867	0.0%	0	includes full LITO & SATO & no MC
26868	30000	37.5%	1175	MC levy shades in SATO shades out
30001	31608	56.5%	2083	tax step + SATO continues shade out
31609	45907	48.0%	8947	LITO starts shade out SATO shade out ends
45908	48749	35.5%	9956	LITO shades out
48750	75000	31.5%	18225	Tax rate only up to next tax step
75001	150000	41.5%	49350	tax step
150001	limit	46.5%	limit	tax step

The pattern is similar to other singles shown above. High EMTRs are occasioned by LITO reduction, SATO reduction and MC shading in.

The Government always tries to keep as many as possible to a zero tax level, but those that fall beyond the limits face EMTRs that remain above 31.5%. Again the problems are caused by the offsets which diminish.

But are high EMTRs a problem? Perhaps not to the same extent as NSers at the point of entry into the workforce. But nevertheless a disincentive, maybe even more so if part time work is contemplated.

Of course it can be argued that these rates are not excessive, that they a reasonable trade-off against a higher tax free threshold and in any event, not many age pensioners fall into the taxable category.

Now the case of a single senior with an age pension.

**Table 18: Single Senior with Age Pension**

From	To	EMTR	Taper rate	Tax rate	Tax at top of range	
0	3432	0.0%	0.0%	0.0%	0	Full AP,SATO and LITO
3433	26867	40.0%	40.0%	0.0%	0	AP taper starts at 40%
26868	30000	62.5%	40.0%	37.5%	1175	SATO reduction & MC shade in starts
30001	31608	73.9%	40.0%	56.5%	2083	LITO reduction starts
31609	39351	68.8%	40.0%	48.0%	5800	MC levy fully phased in AP taper ends
39352	45907	48.0%	0.0%	48.0%	8947	SATO reduction finishes
45908	48749	35.5%	0.0%	35.5%	9956	LITO reduction ends
48750	75000	31.5%	0.0%	31.5%	18225	Tax rate only up to next tax step
75001	150000	41.5%	0.0%	41.5%	49350	tax step
150001	limit	46.5%	0.0%	46.5%	limit	tax step

Take note of the EMTRs. Once tax starts being payable, the EMTR remains above 60% until \$39,351, before falling to 48%. This highlights the fact that a heightened tax free threshold come with the pain of heightened EMTRs.

For sceptics and by way of explanation, the maximum EMTR of 73.9% is made up as follows

- 40 % taper rate re age pension
- 30 % tax rate
- 12.5% reduction in SATO
- 4 % LITO reduction
- 10% Medicare MC shade in
- Less tax effect of taper 56.5% of 40% = 22.6%

A grand total of 73.9%.

Each year the Government fiddles with rates and offsets to relieve the pressure on some. But the same problem persists year after year. It is even more stark when one compares this to those over 60s with large amounts of concessionally funded super.

There appears to be some seriously incompatible goals and objectives set out in the Tax Review’s terms of reference. The Review is required to look to at ways to improve “the tax and transfer payment system for individuals and working families, including those for retirees” while preserving” tax-free superannuation payments for the over 60s” yet “provid(ing) equity (horizontal, vertical and inter-generational)”.<sup>13</sup>

Equity will be an Orwellian version where some are more equal than others.

Working out a TT for a taxpayer and/ or a couple is the same as demonstrated above for other taxpayers. The existing tax free thresholds for seniors give a clue to the additional senior supplement that needs to added to the basic adult TT amount to get to an acceptable TT amount for a single senior i.e. a supplement of \$15,000 added to the basic adult TT of \$11,000 equals \$26,000. The position for an age pensioner with increasing levels of income is as follows.

**Table 19: Single Age pensioner**

TT	26000	26000	26000	26000	26000	26000	26000	26000
Other Income	0	2000	4000	6000	11000	20000	30000	35000
AP	14000	13200	12400	11600	9600	6000	2000	0
TI	14000	15200	16400	17600	20600	26000	32000	35000
Tax	0	0	0	0	0	0	1800	2700
Net	14000	15200	16400	17600	20600	26000	30200	32300
EMTR		40%	40%	40%	40%	40%	58%	58%

In exchange for accepting much higher TTs, seniors can forgo the 15% tax band so that when tax becomes payable when TI exceeds TT, the rate is 30%.In the above case EMTR is 40% being the taper rate, until tax starts with TI = \$26,000. The 30% VB rate plus the

<sup>13</sup> See Terms of Reference <http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1376>



taper means EMTR is 58%<sup>14</sup>, still less than their current situation (see Table 17). There is no compelling need to stick to the same tax steps. If different TTs are acceptable, then so should different VBs.

For a pensioner couple the supplement used as part of the TT calculation could be say \$22,000 (joint) thus giving a total joint TT of \$44,000. Their individual 30% VB could be say \$35,000 before the 40% VB commences.

Now to the question of the concessionally funded superannuants.

Tax free super payouts for over 60s is off limits as part of the Tax Review so some of the issues that are relevant when comparing over 65 superannuants with over 65 age pensioners are separately canvassed in the Appendix.

The suggestions in the Appendix are, broadly that

- All super funds' earnings should continue to be taxed at 15% even in the pension stage.<sup>15</sup>
- The concept of a minimum pension amount is scrapped.
- Withdrawals from super funds past 65 be subject to raised TTs and be largely tax free. Incentives should be such that a full withdrawal plan be instituted during Members' lives.
- All withdrawals be taxable income but subject to a raised TT to make them largely tax free.
- Super becomes a policy of funding retirements, not a tool for estate planners to vest favours on the next generation.
- Death benefit payments to tax dependents to remain tax free.
- Death payments to non tax dependents be subject to 15% tax.

Let's give them the same TT as the age pensioners, \$26,000 for a single and \$44,000 for a couple.

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<sup>14</sup> With a VB of 15% the EMTR would have been 49%.

<sup>15</sup> The question of tax on the earnings on over 60s super balances is open to the Tax Review.

Now let's assume a single makes a \$70,000 withdrawal from a pension account, all taxable (no tax free component). With a TT of \$26,000 and a 30% VB, the tax payable is \$13,200.

But if a pension offset of 15% similar to that which existed prior to 1<sup>st</sup> July 2007 was allowed<sup>16</sup> the tax payable would become \$6,600.

But rather than reintroduce an offset, simply increase the TT by 50% of the amount that the taxable super amount exceeds the TT. In this case 50% of \$44,000 equals \$22,000, so the TT becomes \$48,000 instead of \$26,000., and therefore tax payable on the \$70,000 withdrawal is 30% of \$22,000 which equals \$6,600.

The TT increase will also apply in cases where taxpayers have part age pension and part superannuation pension. Here TTs will be adjusted to the extent that the taxable component of superannuation pensions contributes to the excess of TI over the TT amount.

The Better Superannuation changes have cause problems of equity to flow through the system.

Whatever TTs and VBs are granted to superannuants, they need to be given to age pensioners as well.

An alternative may be that even with a raised TT, all over 65s could be granted a 15% VB.

As well, to the extent that TI in excess of TT results from a withdrawal from a super fund, a further TT adjustment could reduce the tax to zero. But when superannuants move

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<sup>16</sup> And which still exists for allocated pensions and TRPs for under 60s.

into the 30% VB, tax will become payable. But in the vast majority of cases super will be tax free.

But at least tax will continue to be paid on earnings and amounts at the end paid to non tax dependents will attract a tax of 15%.

Maybe this is a way of largely preserving tax free super, but still reintroducing a little fairness back into the system.

## **Conclusions**

The proposal establishes a more consistent and logical framework which will allow for the integration of the tax and transfer payment systems.

Once having established a framework, other policies can then be applied using the structure

- Vary TTs or VBs
- Categorise new assistance measures as Types 1, 2 or 3, which determine whether they are to be tapered, made subject to a TT reduction, or granted a higher TT.

It has been shown how the proposal will work for singles and couples, with or without children, and with or without NS.

It can be easily adopted to fit age pensioners.

Catering for the over 65s who don't qualify for an age pension is a little difficult at this stage unless some semblance of horizontal and vertical equity is restored.

It was demonstrated how in the matter of Child Support Payments how the system of transferable TTs can work, how a TT can be transferred from a custodial parent to a non custodial parent.

If it were clear what policy reasons exist for the Baby Bonus, then it too could be included in the proposal. Is it a reimbursement? A compensation payout? An incentive to procreate?

The policy reasons for child care assistance are a little less obscure. So it too could easily be incorporated into the proposed system. But should child care be subject to a TT reduction (a Type 2 benefit)? Or should it be a Type 3 benefit? Or maybe secondary income earners may instead be granted an enhanced 15% VB.? Is child care assistance an attempt to entice secondary income earners (mainly women) back into the workforce by addressing the problem of their higher wage price elasticities? Or is it an across the board handout to all?

The existence of the more pertinent wage price elasticities is acknowledged, and the over emphasis in the paper on lowering EMTRs may be a little misleading. Lower EMTRs will assist but they may not always be sufficient. In any event lower EMTRs are preferable to higher ones and if EMTRs are smoother, it will allow policy maker to focus on clearing 'blockages' or minimising the 'bunching up' effects that occur particularly when there is a move from welfare to work.

The current approach where high EMTRs are simply addressed by increasing offsets is like continually attending brush fires. The causes of the problem have been allowed to remain for too long. It's time for the tax and CL systems to merge.

## Appendix: Tax free super for over 60s

The policy reasons for making super for over 60s tax free are a little obscure

- There was no widespread demand to make it tax free.
- Most super was tax free at that stage. Very few had post 1983 balances exceeding \$130,000 (the tax free amount at that stage)
- Even so why make it exempt and non assessable which leads in turn to flow on benefits? (e.g. nil MC is payable, nil income means other benefits such as PBS benefits are available<sup>17</sup>).
- Take a case of a resident who might earn Australian investment income as well as an overseas salary. He won't pay Australian tax on overseas income but in assessing the tax on the Australian income the overseas income is notionally included so that a tax free threshold and favourable lower tax rates are not granted. It's akin to investment losses, salary sacrificing and reportable FBT benefits being included to derive a figure for family income for FTB purposes.
- But in the case of the new super changes all the super withdrawals are exempt and non assessable.
- Most independent tax and economics commentators struggle to support the changes on equity grounds, for instance Prof John Head saying he has "never seen anything so inequitable or inefficient as the superannuation tax concessions of 2006".<sup>18</sup>
- The clamour to reduce the top rate of tax from 46.5% has been muted by the generosity shown to over 60s. Also, most over 55s, with any reasonable super balance have commenced a Transition to Retirement Pension TRP which combined with a salary sacrifice agreement reduces their EMTR by 15 % (approx). The only people left clamouring for lower tax rates are those who place a large premium on self interest and are still under 55 years of age and a few unrepentant supply siders.

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<sup>17</sup> This is being addressed in the 2008 Budget.

<sup>18</sup> An article in The Weekend Australian Financial Review May 17-18, 2008.

- In practice what is happening as a result of the super changes is to start a whole range of tax and estate planning opportunities only available to higher income earners. The possibilities are endless and they will be exploited to the full. Super has proceeded beyond merely providing Mum and Dad with a secure retirement. Super is now being used as a family savings pool. Family Trusts Mark 2. Is this the intent of public policy?
- Very few superannuants with large balances will ever pay a ‘death tax’ (i.e. as a result of a payment to a non tax dependent). It will only occur in the proverbial ‘run over by a bus on the way home from the gym’ situation.
- With wealthier over 65s receiving non assessable super income, they will ideally placed to receive additional amounts from family trusts and businesses to take advantage of their low marginal tax rates. Is this the intent of public policy?

Tax free super for over 60s shouldn’t be so sacred that it is shielded from scrutiny. It’s like a LITO of \$2,100. It may sound like a good idea at the time, but a closer examination reveals all the inequities.

Providing concessionally taxed super to allow retirees to live a comfortable retirement is one thing. But this shouldn’t necessarily mean that tax needs to be forgone on much of the earnings, and that all withdrawals are tax free? To quote the current PM when he became leader of his party, it is “a bridge too far”.<sup>19</sup>

If the tax and CL systems are to be integrated then there a few matters that need to be sorted out

- The existence of RBLs implied a public policy limit to concessionally funded super per taxpayer.
- Then all of a sudden there was no limit and many received large windfalls.
- Is the sole purpose of super still to provide retirement benefits for retirees or to assist them in aiding the next generation?

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<sup>19</sup> See Kevin Rudd’s first press release as alternative PM 4<sup>th</sup> Dec 2006.

- And why was 60 chosen as the age for tax free super when the age pension age was 65. The age 60 threshold opens the door wide open to more estate planning opportunities
- Why is the assets test limit (for an age pension) for a couple approximately \$970,000?
- Why is the tax free limit for a senior couple approximately \$44,000.
- Why is the incomes test limit (for an age pension) for a senior couple almost \$66,000.
- Why is all super for over 60s non assessable income.
- And why introduce the proportioning rule in its current form?

Because the policy reasons for all the changes are obscure, it's a little difficult to participate in a policy discussion.

Should all withdrawals from super be tax free or should they be aligned in some way with the CL system which will cover most retirees for quite a while in the future.

Public policy has deemed that \$970,000 in assets doesn't warrant any further income support. Let's say \$1m. For retirement income streams the minimum amounts each year, as a % of the account balance varies with age from 4% to 14%. With \$1m in super at 65, a couple can draw out the greater of the minimum required and the tax free amount (indexed) over a 30 year period and still have some cash left at 95 years, and all of their withdrawals will have been tax free.

Does this reflect the Government's policy on tax free super for over 65s?

Or are all super amounts to be tax free, above and beyond that required to live comfortably in retirement, despite the fact that much of the earnings have been tax free and their brethren on age pension are subject to incomes and assets tests?

On equity grounds there is an argument that withdrawals from taxed super funds be tax free up to the generally available TT but that excess amounts should be taxable at the VB rate of 15 %.(or increase the TT so that an effective rate of 15% applies).

The basis in the past for allowing a 15 % offset on retirement income streams was the ‘quid pro quo’ argument. If it were taxed at 15% on the way in then a 15% rebate should be allowed on the way out. There was some merit in the argument although it did overlook the fact that pension earnings were tax free.

But then on 1<sup>st</sup> July 2007, all withdrawals were made tax free, at a time when less and less of the lifetime earnings of a Fund are likely to be taxed. Consider the following

- Pensioners are living longer
- With TRPs starting at 55 years, and with the expected earnings of a fund in the pension stage (for 30+ years) far exceeding the earnings in the accumulation stage, most of a Fund’s earnings are untaxed , yet are tax free upon withdrawal. Horizontal equity?
- The amount of untaxed earnings are increased by the fact that realisation of assets is often deferred (in DIY Funds) as the Member approaches preservation age and access to a TRP.

So at the very least, pension funds should continue to be taxable on their earnings.

But why commence a pension? Currently one of the principal reasons for commencing a pension is that the income from the assets supporting the pension becomes tax free. But it would be easier to scrap the minimum amounts <sup>20</sup>and just let members decide on a withdrawal strategy.

The reason one should be encouraged to commence withdrawals is to take advantage of the increased TTs that apply to over 65s in a manner in which superannuation was intended.

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<sup>20</sup> Contained in Schedule 7 of the Superannuation Industry (Regulations) 1993



If a Fund continues to accumulate past 65 that's the Member's choice. And if there's anything left upon death, it goes tax free to tax dependents. However non tax dependents will have to pay 15%, which only takes the tax take up to 30%, equal to the corporate tax rate and the marginal tax rate that most taxpayers face. And that's a lot lower than excess benefits tax prior to Better Superannuation.

Currently Better Superannuation allows, a single superannuant, for example, to either

- withdraw his entire super, tax free, on his death bed and pass it to his beneficiaries, **or**
- use the proportioning rule to its fullest to ensure payments/commutations to non tax dependents in the case of sudden and unexpected death are tax free, **or else**
- leave the non tax dependents with a 16.5% tax

Is this equitable? Does equity rely of obtaining the best advice? Should equity be less if a sudden catastrophic event occurs?

Under the current rules the proportioning rule allows for payments to non tax dependents to be paid in the same proportions as existed at the time of the commencement of the pension. The proportioning rule is a Magic Pudding for estate planners.<sup>21</sup>

Because all super for over 60s is tax free, the break-up of a super interest between the taxable component and the tax free component seems only of academic interest because it's tax free anyway. It certainly is if paid to a member or a member's tax dependent ( e.g. spouse).

But if paid to a non tax dependent (e.g. an adult child) tax of 16.5% will be payable on the taxable component. So where possible, particularly between 60 and 65 years, members make tax free withdrawals and immediately redeposit them as non concessional

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<sup>21</sup> The Magic Pudding (c1918) written by Norman Lindsay, ostensibly a fable for children, introduces the Magic Pudding. As one of the characters Bill explains 'The more you eats, the more you get'. The proportioning rule works in the same way.

deductions before reaching 65, after which the work test may restrict such transactions. This increases the tax free component.

Once a pension (or retirement income stream to give it the correct name), commences, the proportioning rule determines the split up between taxable and exempt components, which remain fixed over the life of the pension even if it is commuted.

Theoretically the amount of the tax free component at the commencement of the pension can be drawn out several times over, earnings permitting. Hence all withdrawals can be structured to be tax free, even to non tax dependents.

The proportioning rule is such that if a pension starts with 100% tax free component, it can be also be commuted to a non tax dependent 100% tax free.<sup>22</sup>

A Magic Pudding indeed!

What are the equity arguments for this?

The spirit of super, being a way to encourage setting aside funds for retirement, is being modernised into a family savings pool. Is this the aim?

If this is so, then it needs to be publicly spelled out. Integration of the tax and CL systems require, as a prerequisite, that some consensus be reached on these matters.

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<sup>22</sup> The proportioning rule is contained in S 307-125 of the Income Tax Assessment Act 1997. There is provision in the section for the Commissioner of Taxation to use Regulations to specify an alternative method to calculate the components of a superannuation benefit, but at this stage it is unclear when the commissioner might use his discretion.